

Rampant China and Supply Chain Security in SE Asia: A Plan For Subic Bay



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OVERVIEW

China continues to reinforce its territorial claims in the South China Sea through land reclamation and island-building projects. China appears to be developing an effective anti-access/area denial (A2/AD) program, equipping the new installations in the Paracel and Spratly Islands with anti-air missile batteries, submarine-hunting materiel, and (rumored) intermediate-range ballistic missiles that can target Guam or Australia. This drives the requirement for US and allied stakeholders to maintain contingency logistics and supply chain capabilities to safeguard against disruptions in the event of naval conflict shutting down access to the South China Sea. This paper suggests how Subic Bay can and should be deployed as a rapidly-available solution to this problem.

The goal of this program is to implement a three-fold business model of regional multimodal shipping, warehousing and manufacturing, and closed-loop sourcing and strategic procurement for stakeholders. By creating these mutually-reinforcing profit centers, the Philippines and United States will benefit from building an economically sustainable private sector logistics capacity that can be repurposed immediately into a strategic sealift and logistics operation should the regional geopolitical climate shift precipitously. Such an antifragile model offers unlimited strategic flexibility for all stakeholders.

For these reasons, it is in the interest of the US and allied stakeholders to develop a robust, synergistic dual-use presence at Subic Bay. With long-term shipping constraints between SE Asia and the US, the need for contingency naval supply chain capacity in the South China Sea theater, and opportunity to restore strong bilateral relations with the Philippines, a comprehensive logistics partnership in Subic Bay will provide myriad benefits towards establishing lasting peace and prosperity for the region.

HISTORY

Subic Bay, Philippines was once the US Armed Forces' largest overseas military installation, operating as a major ship repair, maintenance, and force projection facility. After closure of the base in 1992 due to a disagreement with the Philippines' government over leasing costs and the presence of nuclear weapons, the port and facilities were turned into a commercial freeport zone. The US Navy still utilizes Subic Bay to some extent, though the robust Visiting Forces Agreement it once enjoyed was revoked by President Duterte in February 2020 over tensions between the two governments.

In 2004, Hanjin Heavy Industries opened a massive shipbuilding operation in Subic Bay, constructing large containerships, multi-purpose vessels, and tankers. After a massive debt default and failed restructuring in 2019, the Hanjin facility became available for sale. Austal, a major Australian shipbuilder and close US partner, has joined with American private equity firm Cerberus in a bid to take over and revitalize the Hanjin facility. As of July 1, 2020, Austal is slated to be the front-runner over competing British and Japanese firms to acquire the facilities and repurpose them to military naval vessel newbuild and repair.

BUSINESS MODEL

The Subic Bay program will consist of a three-part business model:

1. Regional feeder vessel service (between ASEAN nations and Philippines) and Trans-Pacific blue water ocean cargo service (between Philippines and US)
2. Multimodal logistics operations and warehousing in Subic Bay Freeport Zone
3. Support and sustainment operations for stakeholders to include the US Navy, US-allied navies, Austal/Cerberus, and commercial clients

Each of these domains of operations are essential to the whole model, providing mutually-reinforcing commercial opportunities that drives the requirement to keep logistics capacity at military readiness levels.



Image 1 - Subic Bay Logistics Hub Locations

Let's explore each of these domains in detail.

Ocean Vessel Service

From pharmaceuticals to electronics to chemicals and rare earth metals, the US has never been more reliant on a near-peer adversary for its critical and consumer supply chains. President Trump promised to change this fact, launching an ongoing trade war that has successfully forced the transition of many US importers and retailers away from manufacturing in China, to manufacturing in the ASEAN economies. A transformation has thus been underway in Southeast Asia since the election of US President Trump in 2016. One of the linchpins of President Trump's foreign and economic policy has been working to rebalance the enormous economic dependence the US consumer base has on Chinese-produced goods.

It is essential that goods manufactured in the ASEAN nations - especially Malaysia, Thailand, Vietnam, Philippines, and Indonesia - have cost-effective and rapid access to North American markets. These economies are benefiting enormously from the shift away from manufacturing in China, but are constrained in their time to market by a slower-than-expected shift in ocean carrier capacity. To this point, the steamship lines continue to favor China due to its importance to mega-importers such as Wal-Mart, Target, and Amazon. This leaves the new manufacturers in the ASEAN nations and their buyers in North America short on access to reliable transportation.

The missing piece for previous plans to turn Subic Bay into a major transshipment hub has been the relative lack of backhaul and multi-revenue opportunities. Under a traditional transshipment model, the majority of revenues are derived from typical port activities, such as cargo handling, yard storage, blocking/bracing, and container freight station services. This model requires a high density and consistent volume of cargo coming in from multiple carriers and alliances, and has little room for disruption in flow of cargo in the event of black swan events such as war, power outages, or natural disasters.

Complicating matters is the natural draft of 13.7 meters at quayside, which prevents berthing of ships larger than Post-Panamax I class (vessels larger than 6,000+ TEU). The present Trans-Pacific transshipment model is built predominantly around a small number of regional mega-ports that can handle the massive VLCS and ULCS classes of vessel, such as Shanghai,

Singapore, and Hong Kong. With huge investments into these enormous (but slow) ships at \$175 million or more per newbuild, the steamship lines have every incentive to streamline as much as possible towards global hub-and-spoke models that utilize the bigger ships for blue water voyages. As we have seen in the aftermath of COVID-19 and manufacturer relocation to countries with shallower ports, this greatly constrains the flexibility of steamship lines to service the shift in demand.

Our proposed solution is to provide a nimble, high-speed transshipment and logistics solution based in the Subic Bay Freeport Zone in the Philippines. First, this would require an efficient feeder service that can reliably and routinely transport cargo from the overly-congested origin ports of SE Asia to the SBFZ for storage, kitting, and transshipping to North America. Once a density of cargo is reached, Panamax-size (or smaller) containerships and multipurpose vessels can fast steam from Subic Bay directly to the US West Coast in 11-13 days. Return trips could notionally provide logistics service to Honolulu, Guam, and Philippines in 13-15 days.

The primary feeder route is recommended to service Port Klang, MY; Songkhla and Bangkok, TH; and Ho Chi Minh City, VN through the South China Sea. This optimizes for speed and cost efficiency. Future port calls (such as Indonesia or Cambodia) could be added or subtracted as cargo density shifts. We expect weekly demand for this service to grow to thousands of TEU's within months of project inception. The goal is to be scalable to the emergent growth trends and ease demand on the normal steamship line services between SE Asia and the US, especially those which transship through China.

Payoff: Blunting Chinese Belligerence

The most desirable strategic feature of this plan from a US perspective is that it sets up an immediately available contingency capacity for Chinese belligerence, one that allows feeder vessels to continue operation even in the event of a security risk in the South China Sea. This contingency route would see the vessels transit the Java Sea and through the Makassar Strait to approach Subic Bay from the east side of Palawan. By avoiding China's belligerent territorial claims inside the "Nine Dash Line", SE Asian shippers will not find themselves constrained to the much longer westbound transit times through the Red Sea to North America.

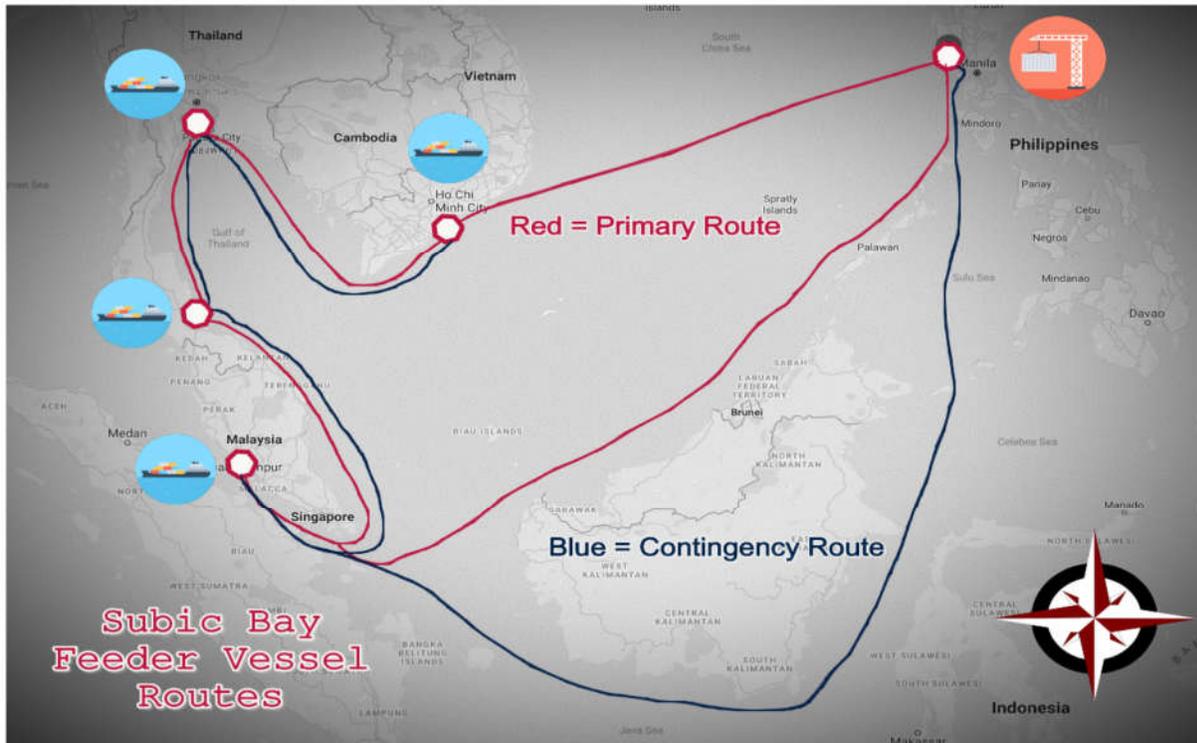


Figure 2 - Feeder Vessel Routes between SE Asian hubs and Philippines

As of the first week of July 2020, shippers from these main ports are seeing the worst capacity crunch in modern memory. In Week 25 (June 15-21), steamship lines reported only about 7% additional space above average volumes. In Week 32 (August 3-9), that number is projected to be only 1%. Under normal circumstances, the carriers would start adding in additional vessels to the rotations, easing the crunch. However, thanks to the disruption of COVID-19 causing such massive losses during Q1 2020, the carriers are opting to keep space limited and rates high in order to recover the lost revenue. Where capacity can be “flexed” back in, the carriers are favoring Chinese port calls versus SE Asia. Information coming from the carriers indicates that this is a durable situation, with a tail of 18-24 months expected at a minimum.

Multimodal Logistics Operations in Subic Bay

Critical to providing timely, cost-effective ocean cargo service will be the port and terminal itself. With two berths and a draft of up to 13m, Subic Bay International Terminal (SBITC) can notionally handle up to two 6,000 TEU vessels at once. Operationally, this might be two inbound feeder vessels, one inbound feeder and one outbound Trans-Pacific ship, or two outbound T-P ships. The efficient shoreside cranes and lengthy quay allow for versatility in vessel and cargo

handling, whether containerized, reefer, RORO, dry bulk, or breakbulk. SBITC's longshoremen are hard-working and proficient, turning cargo quickly with excellent dwell times. Further, SBITC's terminal handling charges are 48% lower than Manila's. This positions Subic Bay well from both a cost and efficiency standpoint.

Adjacent to the Subic Bay International Terminal is the excellent Subic Bay Freeport Zone (SBFZ), boasting multiple sizable modern warehouses, updated road infrastructure, and a large cargo airport that once served as FedEx's Asian consolidation hub. SBFZ offers all of the traditional benefits of a freeport or free trade zone, including deferred duties for imported products, as well as no duties for products being stored, repaired, remanufactured, and re-exported from the zone. Collectively, the SBFZ is a turnkey operation that offers importers, exporters, and transshippers alike a strong asset base to serve a variety of logistics needs.

Additionally, the program would have access to local land and investment support from private parties and SBITC's parent company, ICTSI Group. Further, Subic Bay offers a competent, professional labor force experienced in maritime and logistics commerce. Lastly, the Subic Bay Metropolitan Authority has historically offered strong support for mutually-beneficial programs that require the full civil support needed for implementation and ongoing success. This combination of assets, financial and human capital, and cooperative mindset is the glue that will build stakeholder confidence in the early days of the program.

Sustainment and Support Operations

Two key features of a robust, expanded transshipment hub operating in Subic Bay are the myriad supply chain benefits offered to the local industrial base (especially shipbuilding), as well as the return of the military-economic revenue historically enjoyed by the Subic Bay locality.

To the first domain, we anticipate that any of the eventual winners to take over the former Hanjin shipbuilding facility in Subic Bay will call for extraordinary logistics support. Military naval vessels require many thousands of parts both small and large, mandating a versatile and scalable local logistics operation to store, maintain, and deliver the supply chain of components. In the event of a successful bid by Austal and its American capital partner Cerberus, many of the parts and supplies will likely be sourced from Austal's network of subcontractors in North America. This offers a ready-made base of freight that can be backhauled from the United

States to the Philippines, stored duty-free in the freeport zone, and delivered on a JIT basis to the shipyard across the bay.

The program will seek deep integration with Austal and its global network of subcontractors, seeking to maximize operational efficiency and enhance Austal's ability to win vessel newbuild and repair contracts that will drive growth in skilled labor jobs and nurture a local cottage industry of suppliers. Importantly, the Philippines has seen a decline from 2018 into 2020 of foreign direct investment largely due to tax policy uncertainty, COVID-19, and high domestic logistics costs. We expect that the combination of more regular throughput at SBITC/SBFZ and the entrance of a new shipbuilding partner will drive renewed FDI into Subic Bay and the surrounding region.

This new investment activity will flow directly into the second domain, expanding capacity for handling of defense materiel. It is no great secret that the South China Sea theater is on edge with renewed Chinese aggression and expansionism - especially in the Spratly Islands, a mere 90 nautical miles from Palawan, and roughly 300 nautical miles from Manila. The increased Freedom of Navigation Operations (FONOPS) conducted by the US Navy and her allies through the South China Sea is likely to continue, and any increased hostilities will drive an immediate requirement to move naval sustainment and supply chain operations as close to the theater as possible.

Conclusion

Chinese belligerence is no longer a distant potential: we are already seeing aggressive moves against Hong Kong, India, Vietnam, and Taiwan. The probability is that the United States will soon face a challenge that will disrupt our shipping routes from Southeast Asia. We should take immediate action to blunt China's power over these essential shipping routes. Given the legacy of partnership between the Philippines and United States at Subic Bay and long distance from US bases in Japan and Guam, it would be reasonable to make Subic Bay a major resupply, repair, and sustainment hub for combined arms operations in the region. As this paper shows, that will also give us the ability to blunt Chinese attempts to use shipping as a strategic weapon against the United States and our allies.

The Philippines and its allies have a unique opportunity to create a highly synergistic, dual-use logistics hub at Subic Bay. The requirements and incentives have never been stronger. As the economic center of gravity for North America tilts more towards the ASEAN nations and away from China, it is in the best interests of all stakeholders to adopt a long-term strategy towards growing Subic Bay into *the* maritime and air cargo hub for the region. This includes putting new ocean vessel capacity and routes into play, both intra-Asia and Trans-Pacific, driving manufacturing and technology innovation initiatives in the Philippines, and supporting in both word and deed the growth of peace and prosperity for all friends of liberty in the region.

This dual-use capability of the Subic Bay option makes Subic Bay more important than ever to commercial operators and stakeholders who have long-term committed investments in the ASEAN zone. Further enhancing Subic Bay's utility is its ability to host joint combined arms training exercises and temporary materiel handling/storage for the various Philippine, American, and allied forces. Interoperability of assets, communications, and strategy is of paramount importance in these days of PLA-N belligerence in the region. With commercial activity driving new investments into infrastructure and sustainment capabilities, Subic Bay thus achieves a level of economic antifragility, where benefit continues to flow regardless of the regional security situation.